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IN THE

Supreme Court of the United States

ASA INVESTERINGS PARTNERSHIP,
AlliedSignal Inc.
(now Honeywell International Inc.),
Tax Matters Partner,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Does *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943), establish (1) a single-prong "business purpose" test for determining whether an entity may be disregarded for Federal income tax purposes, as the D.C. Circuit held below in concluding that petitioner was a "sham," or (2) a two-pronged, alternative "business purpose or business activity" test, as *Moline* itself states and numerous other Courts of Appeals have held and under which, as the D.C. Circuit itself acknowledged below, petitioner must be respected for tax purposes?

2. Does *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949), which focuses on the purpose and intent of the parties, apply to determine whether persons are partners in a partnership when they form an unincorporated venture in which capital is a material income-producing factor, as the D.C. Circuit held below, or does IRC Sec. 704(e)(1) override *Culbertson* and treat all persons who acquire a capital interest in such a venture as partners in a partnership, irrespective of their purpose and intent, as the Seventh Circuit has held?

3. If *Commissioner* v. *Culbertson*, *supra*, applies, can the purpose and intent of persons forming an unincorporated venture in which capital is a material income-producing factor properly be determined without considering whether they made capital contributions to the venture?

RULE 29.6 STATEMENT

Petitioner, ASA Investerings Partnership, was an investment partnership formed by AlliedSignal Inc. (AlliedSignal), AlliedSignal Investment Corporation (ASIC), Barber Corporation N.V. (Barber) and Dominguito Corporation N.V. (Dominguito). Of those four corporations, only AlliedSignal (now Honeywell International Inc.) has issued shares and/or debt securities to the public. Algemene Bank Nederland N.V. (now ABN Amro Bank N.V.), the indirect parent of Barber and Dominguito, has issued shares and/or debt securities to the public.

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IN THE SUPREME COURT OF THE UNITED STATES

ASA INVESTERINGS PARTNERSHIP,
AlliedSignal Inc.
(now Honeywell International Inc.),
Tax Matters Partner,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

OPINIONS BELOW

The opinion of the United States Court of Appeals for the District of Columbia Circuit is reported at 201 F.3d 505 (D.C. Cir. 2000). The court's opinion is reproduced in the Appendix at pages 1a-23a. The court's orders denying rehearing and rehearing en banc are reproduced in the Appendix at pages 67a-68a.

The opinion of the United States Tax Court is reported at 76 T.C.M. (CCH) 325 (1998). It is reproduced in the Appendix at pages 24a-58a. The decision of the United States Tax Court is not reported. It is reproduced in the Appendix at pages 59a-66a.

JURISDICTION

The judgment of the United States Court of Appeals for the District of Columbia Circuit was entered on February 1, 2000. Petitioner's timely filed petitions for rehearing and rehearing en banc were denied on April 24, 2000. App. 67a-

68a. The jurisdiction of this Court is invoked under 28 U.S.C. Sec. 1254(1).

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

The statutory provisions involved are Sections 453, 704 and 761 of the Internal Revenue Code of 1986. The relevant portions of those provisions are set forth in the Appendix at pages 69a-71a.

The Treasury Department regulations involved are Temp. Treas. Reg. Sec. 15A.453-1(c), Treas. Reg. Sec. 1.704-1(e), and Treas. Reg. Sec. 1.761-1(c). The pertinent portions of those regulations are set forth in the Appendix at pages 74a-79a.

STATEMENT

A. Relevant Facts

1. Background.

Petitioner was an investment partnership formed under New York law in April 1990. The partners were AlliedSignal Inc. (AlliedSignal, now known as Honeywell International Inc.); its wholly-owned subsidiary (ASIC); and Barber Corporation N.V. (Barber) and Dominguito Corporation N.V. (Dominguito), two newly-formed Netherlands Antilles corporations indirectly owned and controlled by Algemene Bank Nederland N.V. (ABN), a major Dutch bank.

The idea for the formation of an investment partnership such as petitioner was developed by Merrill Lynch. The partnership would invest in high-grade, interest-bearing securities and distribute the income from such investments to its partners. App. 26a-27a. Certain of its contemplated transactions would give rise to a potential tax benefit in the form of noneconomic capital losses. There would also be an

opportunity to realize significant economic profits from movements in interest rates. AlliedSignal has acknowledged throughout that it would not have entered into the partnership but for the potential tax benefit.

At AlliedSignal's request, Merrill Lynch provided details of the proposal, including a suggested timetable for certain events. It also arranged for ABN to participate in the venture. ABN and AlliedSignal had a pre-existing business relationship. ABN viewed its participation in the partnership as a way to earn income while enhancing its business relationship with AlliedSignal. App. 7a and 29a.

2. Pre-Formation Activity.

At a meeting in Bermuda in April 1990, AlliedSignal and ABN agreed to form an investment partnership under New York law and to enter into a formal partnership agreement. At the Bermuda meeting, the parties also orally agreed that AlliedSignal would be responsible for all expenses of the partnership and would guarantee that the ABN partners would realize a return on their investment at least equal to ABN's funding costs. (In their subsequent calculations, the parties used LIBOR as the measure of ABN's funding costs.[1]) ABN requested an up-front $5 million fee for its participation. AlliedSignal agreed to pay the fee, but not in a lump sum and only after the occurrence of certain events contemplated by the parties. App. 8a.

Petitioner was funded with $1.1 billion of capital in April and May 1990. AlliedSignal and ASIC contributed $110 million and acquired a combined 10-percent interest in

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[1] LIBOR is the acronym for the London Interbank Offering Rate, the benchmark interest rate used by European banks.

petitioner. Barber and Dominguito provided $990 million and acquired a combined 90-percent interest.

3. Petitioner's Investment Activity.

For a period of 25 months commencing in April 1990, petitioner used its capital to make numerous investments in a wide range of financial instruments. By the time petitioner was liquidated in June 1992, it had earned approximately $113 million in net profits from its investment activity. Those profits were fully reported on petitioner's U.S. partnership income tax returns. Petitioner made profit distributions to its partners at periodic intervals beginning in July 1990, and on a monthly basis beginning in February 1991. The ABN partners received more than $54 million as their share of petitioner's total net profit distributions; AlliedSignal and ASIC received more than $58 million.

The first securities acquired by petitioner in April 1990 were $850 million of private placement notes (PPNs) issued at face value by two banks identified by Merrill Lynch. Petitioner earned $5.8 million of interest on the PPNs before selling them, with the assistance of Merrill Lynch, to two unrelated banks at face value in mid-May 1990. As consideration, petitioner received $681.3 million in cash (including accrued interest) and eleven five-year LIBOR notes of the purchasers valued at $163.9 million.[2] (Costs of $6.375 million, significantly more

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[2] LIBOR notes have a "notional" (*i.e.*, hypothetical) principal amount. Payments made on a LIBOR note are the product of LIBOR times the notional principal amount. Because LIBOR is a floating rate of interest, the total amount to be received on a LIBOR note is uncertain. LIBOR notes thus constitute contingent payment obligations that provide their holder with an opportunity for an interest-rate play in the financial markets, regardless of the direction in which interest rates move. (Rising rates would increase both the amount to be received on the notes and their market value;

(continued...)

than what was anticipated, were imposed on the transaction by Merrill Lynch and were reflected in the reduced value of the LIBOR notes received.)

In the period from mid-May through June 1990, following the sale of the PPNs, petitioner invested in approximately 40 different issues of short-term commercial paper acquired on the open market. As those investments matured, the proceeds were regularly reinvested in new issues of commercial paper and other financial instruments.

4. Tax Consequences of PPN Sale.

For its first taxable year ended May 31, 1990, petitioner reported the sale of the PPNs as a contingent payment installment sale under Sec. 453 of the Internal Revenue Code of 1986 (IRC). Calculation of the gain or loss on such a sale was governed by Temp. Treas. Reg. Sec. 15A.453-1(c)(3), promulgated by the Treasury Department in 1981 in accordance with the specific direction of Congress. *See* IRC Sec. 453(j)(2); App. 70a.

Under the regulations, petitioner's cost basis in the PPNs was required to be recovered ratably over the six taxable years during which it would receive cash payments from the sale. (The effect of the regulations in most cases is to benefit respondent by permitting the early taxation of what is in fact a noneconomic, artificially calculated gain.) Petitioner realized a noneconomic capital gain of $539 million from the PPN sale, calculated as required by the regulations.[3] In accordance with

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[2] (...continued)
falling rates would create a profit opportunity through the use of "swaps" relating to the anticipated payment stream from the notes.)

[3] The receipt of cash proceeds of $680 million, less $141 million (continued...)

their respective partnership interests, petitioner allocated 10 percent of the gain to the AlliedSignal partners and 90 percent to the ABN partners.

The remaining 5/6 of the cost basis in the PPNs ($709 million) would be recovered ratably over the five additional taxable years in which payments were due on the LIBOR notes. Any loss on a note would be recognized on the earlier of final payment or a sale of the note. Temp. Treas. Reg. §15A.453-1(c)(3)(i); App. 74a-75a. A substantial portion of any such loss would likely be noneconomic.

5. AlliedSignal As Majority Partner in Petitioner.

As contemplated by the parties, in early August 1990, AlliedSignal acquired a majority interest in petitioner by purchasing Barber's entire interest and a portion of Dominguito's interest for a total purchase price of $540.6 million. AlliedSignal also paid the ABN partners $4.4 million of the $5 million fee ABN had requested in April.

At this time, interest rates had fallen and petitioner's LIBOR notes had declined in value. As a result, AlliedSignal paid the two ABN partners a total of $3.13 million less than their original investment for their respective partnership interests. App. 52a. Each of the ABN partners thus suffered a loss on its partnership interest.

AlliedSignal had no obligation to cover the ABN losses. They were, however, covered by hedges ABN had previously put in place with Merrill Lynch outside the partnership. Through an exchange of specifically structured payments, the hedges were designed to neutralize ABN's exposure to

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[3] (...continued)
of cost basis in the PPNs (representing 1/6 of their $850 million total cost basis), produced a noneconomic capital gain of $539 million.

fluctuations in the value of the LIBOR notes. When the hedges were terminated, ABN received a net payment of $5.85 million from Merrill Lynch. App. 47a.

Later in August 1990, as also contemplated by the parties, petitioner distributed the eleven LIBOR notes to AlliedSignal and ASIC and a proportionately equivalent amount of cash and financial instruments to Dominguito.[4] At this time, interest rates had returned to prior levels. As a result, Dominguito enjoyed the benefit of an increased portfolio valuation in receiving its share of the distribution.

AlliedSignal and ASIC sold some LIBOR notes in September and November 1990, and the balance in November 1992. Each sale resulted in a capital loss. As calculated in accordance with the regulations, a substantial portion of each loss was noneconomic. AlliedSignal utilized the capital losses as offsets against capital gains it had realized and on which it otherwise would have been taxed. Those gains included its 10-percent share of the noneconomic capital gain reported on the PPN sale. The resulting tax benefit to AlliedSignal was approximately $150 million, of which $19 million represented the tax it saved on the PPN gain.

6. AlliedSignal's Direct Payments to ABN.

In December 1991, the 20th month of petitioner's operation, AlliedSignal made a payment to Dominguito that included the remaining $600,000 of ABN's requested $5 million fee, about $765,000 to cover what the parties then agreed was the "shortfall" to date in petitioner's cumulative profit distributions to the ABN partners below a LIBOR-

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[4] Distribution of the LIBOR notes to AlliedSignal and ASIC ensured that they alone would ultimately absorb the embedded costs attributable to the PPN transaction.

equivalent return on their investment, and $266,000 to cover certain other negotiated items.

When petitioner was liquidated in June 1992, the "shortfall" in petitioner's profit distributions was recalculated and found to be $152,000 less than in December 1991 because of petitioner's investment results since that time. To reflect that fact and certain other adjustments, the parties negotiated for a repayment of $315,000 from Dominguito to AlliedSignal.

The "direct payments" made by AlliedSignal to the ABN partners thus consisted of the $5 million fee, a net "shortfall" payment of $613,000, and $103,000 for other negotiated items. The profit distributions from petitioner to the ABN partners exceeded $54.4 million.

7. AlliedSignal's Investment Strategy.

AlliedSignal's overall investment strategy included, in addition to the receipt of its share of petitioner's profit distributions, the implementation of a series of floating-to-fixed interest rate swaps involving the LIBOR notes beginning in August 1990. Those swaps, which were structured quite differently than the ABN hedges, would enable AlliedSignal to take advantage of what it then anticipated would be a decline in interest rates beginning in the second half of that year.

Interest rates in fact fell steadily for an extended period beginning in November 1990. As a result, even though AlliedSignal incurred both economic and noneconomic losses on its LIBOR note sales, and even though its total costs and expenses had increased from an expected $11-12 million to an unexpected $25 million, AlliedSignal's investment strategy produced an overall pre-tax profit to it of $3.6 million. App. 22a-23a. If its costs had remained as expected, AlliedSignal's overall pre-tax profit would have been $16-17 million.

B. Proceedings Below

1. Tax Court Proceeding.

On audit, respondent objected to AlliedSignal's use of the capital losses realized on the LIBOR note sales without being taxed on 100 percent of the $539 million PPN capital gain reported by petitioner in May 1990.[5]

Respondent did not dispute that his regulations provided for the tax results claimed.[6] Rather, respondent asserted that petitioner was a "sham"; that the relationship between AlliedSignal and ABN was that of debtor-creditor; and that the transactions in question lacked economic substance and should be disregarded for tax purposes.

Petitioner's Tax Matters Partner (AlliedSignal) filed a timely petition in the United States Tax Court under IRC Sec. 6226(a)(1), contending that petitioner was a valid partnership,[7] that it had engaged in valid transactions, and that its application of the "ratable basis recovery" rules on the sale of its PPNs was expressly required by the Treasury regulations.

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[5] Despite the extensive involvement of ABN's New York branch in the activities of the partnership, there is no indication that respondent made any attempt to recover a capital gains tax from ABN or the ABN partners on their share of the PPN gain.

[6] On August 31, 1990, respondent published Notice 90-56, 1990-2 C.B. 344, stating his intention to amend the applicable regulations. No change has been made to date.

[7] IRC Sec. 761(a) defines a "partnership" as including a "...pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on...." App. 70a-71a.

The Tax Court first determined that Barber and Dominguito should be ignored, and that AlliedSignal and ABN were the real parties in interest. Relying on this Court's decision in *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949), the Tax Court then held that AlliedSignal and ABN did not form a bona fide partnership because they did not have the requisite intent to join together in the present conduct of an enterprise. This conclusion was based on the court's view that the parties (1) had divergent business goals, (2) did not share in the venture's profits and losses, and (3) did not comply with their formal partnership agreement when it conflicted with their so-called Bermuda Agreement. App. 54a-55a.

The centerpiece of the Tax Court's opinion was a finding that AlliedSignal had agreed to provide (not guarantee) ABN a "specified return" of LIBOR plus 75 basis points (0.75 percent) on its invested funds, "no more and no less." App. 32a, 50a. Based on that finding, the court declared that the profit distributions made by petitioner to ABN ($54.4 million) were "an artifice" to enable AlliedSignal to pay ABN its "specified return," and that such distributions were supplemented by the "direct payments" from AlliedSignal ($5.7 million) to ensure that ABN received the precise amount it was promised by AlliedSignal. App. 50a.

The "specified return" finding was also used to support the Tax Court's second holding -- that the $990 million in funds provided by ABN had been "loaned" to AlliedSignal. The court equated its "specified return" finding with the finding of an agreement by AlliedSignal to pay interest of LIBOR plus 75 basis points on the loan. App. 57a.

The Tax Court did not consider whether the transactions entered into by petitioner lacked economic substance.

2. D.C. Circuit Proceeding.

On appeal, respondent conceded that ABN's $990 million cash outlay did not appear to be a loan to AlliedSignal because there was no obligation to repay any portion of the funds. (D.C. Cir. Res. Br. 49).

The D.C. Circuit (Williams, Sentelle and Henderson, JJ.) nevertheless agreed with respondent that the Tax Court's holding on the partnership issue was the equivalent of a finding that petitioner was "for tax purposes, a 'sham.'" App. 14a. The court found full support for the Tax Court's position in this Court's decision in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943), a case not relied on by respondent or cited by the Tax Court.

Although the court acknowledged that petitioner engaged in extensive investment activity for two years, it rejected petitioner's argument that *Moline* set forth a two-pronged "business purpose or business activity" test under which petitioner could not be considered a sham. Rather, the court concluded that *Moline* set forth a single-prong "unitary" test, under which "the absence of a nontax business purpose is fatal." App. 15a.

The court concluded that because petitioner was formed for a tax avoidance purpose, and because its purchase and sale of the PPNs in April and May 1990 was business activity undertaken in furtherance of that purpose, petitioner was properly treated as a sham under *Moline*.

The court below also reviewed the Tax Court's *Culbertson* analysis, finding some of it "misdirected." App. 14a. It disagreed with the Tax Court's first point -- that the existence of divergent business goals was a proper basis for denying partnership treatment. App. 14a. It did not comment on the Tax Court's third point -- that the parties did not follow

their partnership agreement when it conflicted with their so-called Bermuda Agreement.[8]

On the Tax Court's second point -- that the parties did not share in the venture's profits and losses, the court stated that it found "no clear error in the [Tax Court's] findings that the direct payments made to ABN were to compensate it merely for its funding costs . . . (plus some amount above LIBOR, even if not 75 basis points)." App. 19a. Although the court thus accepted petitioner's contention that ABN had not been promised a "specified return" of LIBOR plus 75 basis points by AlliedSignal, it said nothing about why the $54.4 million in distributions that ABN received from petitioner did not represent a sharing in petitioner's profits.

With respect to loss-sharing within the partnership, the court below refused to recognize the $3.13 million loss suffered by the ABN partners attributable to the decline in value of petitioner's LIBOR notes in August 1990. The court's justification was that ABN's exposure to such losses had been eliminated through its hedges with Merrill Lynch, notwithstanding that the hedges were put in place by ABN outside the partnership.

Even though there were no Tax Court findings on the point, the court speculated that AlliedSignal "likely" paid for the ABN hedges because it had paid a substantial fee to Merrill Lynch. App. 22a. On the basis of its own speculation, the court viewed AlliedSignal as having "insured" ABN against loss on the value of the LIBOR notes while they were held by

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[8] Treas. Reg. Sec. 1.761-1(c) provides that a "partnership agreement" includes the original agreement and any modifications thereof agreed to by all the partners, whether in oral or written form. App. 79a.

petitioner, an action said not to be within the "traditional notion of partnership."[9] App. 22a.

As for other possible partnership losses, the court concluded that ABN had no credit risk with respect to any of petitioner's other investments because they were AAA- and AA-rated and any such risk was therefore "de minimis." App. 21a. The credit risk on the hedge payments ABN was to receive from Merrill Lynch, a single A-rated credit, was also considered "de minimis" by the court. App. 21a.

The court did not address petitioner's argument that IRC Sec. 704(e)(1), rather than *Culbertson*, should be applied to determine whether AlliedSignal and ABN were partners in a partnership.[10] Rather, the court concluded that petitioner was not a valid partnership because neither party had the requisite purpose and intent to form a bona fide partnership, as required under *Culbertson*.

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[9] The court took no note of the fact that AlliedSignal's $6.75 million fee to Merrill Lynch was payable in four installments over 14 months, that the bulk of the fee was payable well after ABN's hedges had been closed out, and that AlliedSignal delayed payment of the final installment for 17 additional months and then paid Merrill Lynch only $2.3 million of the final $2.8 million due because of its dissatisfaction with the PPN and LIBOR note transaction costs Merrill Lynch had imposed. (D.C. Cir. Jt. App. 0161-62.) On the profit side, the court took no note of the fact that the $5.85 million net payment ABN received from Merrill Lynch on its hedges far exceeded the $3.13 million in losses it suffered as a result of the decline in value of the LIBOR notes in August 1990.

[10] IRC Sec. 704(e)(1) provides that "A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." App. 70a.

Although respondent conceded that ABN's $990 million cash outlay did not appear to be a loan to AlliedSignal because there was no repayment obligation, the court declined to consider petitioner's argument that the funds must have constituted a capital contribution by ABN to petitioner. The court described the loan/capital contribution issue as "quite peripheral" to the question whether the parties had entered into a bona fide partnership. App. 22a.

REASONS FOR GRANTING THE WRIT

The instant case presents one of the most fundamental questions arising under the Federal income tax laws -- when must an entity be respected for tax purposes, and when may it be disregarded as a "sham"?

The decision below is in direct conflict with the governing principles enunciated by this Court in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943). *Moline* sets forth a two-pronged, alternative test for determining when an entity should be respected for tax purposes -- if there is a valid business purpose for the formation of the entity, or it conducts business activity after being formed, the entity cannot be disregarded.

The D.C. Circuit expressly acknowledged that petitioner had engaged in extensive investment activity over a two-year period. But the court concluded that *Moline* set forth only a single-prong "business purpose" test, under which petitioner was properly disregarded as a sham.

The decision below is also in direct conflict with decisions of the Second[11] and Seventh[12] Circuits that have applied *Moline* to respect the existence of an entity that conducted business activity, even though the entity was formed for a tax avoidance purpose and carried on its activity in furtherance of that purpose.

In addition, the decision below is in direct conflict with a decision of the Seventh Circuit[13] regarding the application of IRC Sec. 704(e)(1), rather than this Court's decision in *Commissioner* v. *Culbertson*, *supra*, to determine whether parties forming an entity such as petitioner, in which capital is a material income-producing factor, should be treated as partners in a valid partnership.[14] Moreover, if *Culbertson* governs, the decision below conflicts with *Culbertson* itself on the significance of a participant's capital contribution to the venture.

The instant case is an extremely important case, because the D.C. Circuit is the only circuit to which appeals may be taken by partnerships no longer in existence. IRC Sec. 7482(b)(1); App. 72a-73a. As a result, if the decision below is left unreviewed, numerous partnerships may find themselves governed by the "single-prong" *Moline* test and/or the *Culbertson* rationale adopted below, while other partnerships

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[11] *Gregg Co. of Delaware* v. *Commissioner*, 239 F.2d 498 (2d Cir. 1956), *cert. denied*, 353 U.S. 946 (1957).

[12] *Northern Indiana Pub. Serv. Co.* v. *Commissioner*, 115 F.3d 506 (7th Cir. 1997).

[13] *Evans* v. *Commissioner*, 447 F.2d 547 (7th Cir. 1971). *Compare Bayou Verret Land Co.* v. *Commissioner*, 450 F.2d 850 (5th Cir. 1971).

[14] *See supra* note 10.

subject to the law of other circuits would likely be governed by the "two-pronged" alternative test actually set forth in *Moline* and/or a proper application of Sec. 704(e)(1).[15]

To resolve the *Moline* conflicts noted above, to clarify whether Sec. 704(e)(1) takes precedence over *Culbertson* where capital is a material income-producing factor in the venture, and to eliminate the confusion that is certain to develop among the lower courts as a result of the decision below, this Court should grant the writ.

I. The Decision Below Is in Direct Conflict with the Principles Enunciated by This Court in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943).

This Court first enunciated the governing principles for determining whether an entity is a "sham" for tax purposes in its landmark decision in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943). In *Moline*, this Court refused to disregard a corporation established by an individual at the behest of a creditor. This Court declared that a corporation must be respected for tax purposes if (1) it is formed for a business purpose, or (2) it conducts business activity after its formation. As this Court stated:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to

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[15] The *Moline* aspect of the instant case is not limited to partnerships. Corporations having the D.C. Circuit as their venue for appeal will also find themselves faced with that court's single-prong interpretation of *Moline*.

> serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. * * *
>
> In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction.

319 U.S. at 438-39 (emphasis added; footnotes omitted).

Lower courts have applied the two-pronged test of *Moline* on countless occasions, both to corporations and to partnerships. *Moline* is surely one of the most frequently cited tax cases ever decided.[16]

Notwithstanding the clear language of *Moline*, however, the D.C. Circuit chose to craft its own single-prong, so-called "unitary" test, under which "the absence of a nontax business purpose is fatal." App. 15a. The court expressly acknowledged that if "business activity" were a separate aspect of the *Moline* test, petitioner could not be treated as a sham.

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[16] For a sampling of Court of Appeals decisions applying *Moline* generally, see, *e.g.*, *Sargent* v. *Commissioner*, 929 F.2d 1252, 1259 (8th Cir. 1991); *Gulf Oil Corp.* v. *Commissioner*, 914 F.2d 396, 411 (3d Cir. 1990); *Humana Inc.* v. *Commissioner*, 881 F.2d 247, 252 (6th Cir. 1989); *Vaughn* v. *United States*, 740 F.2d 941, 943 (Fed. Cir. 1984); *Taylor* v. *Commissioner*, 445 F.2d 455, 457 (1st Cir. 1971); *Dodd* v. *Commissioner*, 298 F.2d 570, 577-78 (4th Cir. 1962).

See also the following Tax Court decisions: *Bertoli* v. *Commissioner*, 103 T.C. 501, 511-12 (1994) (partnership); *Bass* v. *Commissioner*, 50 T.C. 595, 600 (1968) (corporation); *Campbell County State Bank, Inc.* v. *Commissioner*, 37 T.C. 430, 441 (1961), *rev'd on other grounds*, 311 F.2d 374 (8th Cir. 1963) (partnership).

> We agree if engaging in business activity were sufficient to validate a partnership ASA would qualify. It was infused with a substantial amount of capital ($1.1 billion), and invested it in PPNs, LIBOR notes, and other short-term notes over a period of two years.

App. 15a. But the court concluded that "courts have understood the 'business activity' reference in *Moline* to exclude activity whose sole purpose is tax avoidance," App. 15a, and that petitioner's purchase and sale of the PPNs was "a business activity merely conducted for tax purposes." App. 16a. On that basis, the D.C. Circuit upheld the Tax Court's determination that petitioner was a sham.

The two cases cited by the court in support of its narrow reading of *Moline* were *National Investors Corp.* v. *Hoey*, 144 F.2d 466 (2d Cir. 1944), and *Zmuda* v. *Commissioner*, 731 F.2d 1417 (9th Cir. 1984). Neither case supports the proposition for which it was cited.

National Investors did not hold that the corporation at issue could be disregarded as a sham on the ground that it had a tax avoidance purpose, or because it carried on activity in furtherance of such a purpose. To the contrary, the Second Circuit (L. Hand, J.) held that the corporation should be respected for as long as it engaged in business activity. The presence or absence of a tax avoidance purpose while the corporation conducted business activity was not even discussed.[17]

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[17] See *Jackson* v. *Commissioner*, 233 F. 2d 289, 290-91 (2d Cir. 1956), for an explanation of *National Investors* and a reaffirmation of the two-pronged *Moline* test by the Second Circuit. See also *Bass* v. *Commissioner*, 50 T.C. at 600, citing *National Investors* in support of its

(continued...)

In *Zmuda*, the other case cited below, the Ninth Circuit held that certain trusts could be disregarded after determining that the trusts lacked both a business purpose and business activity. Any doubt that the Ninth Circuit adheres to the two-pronged *Moline* test should be eliminated by that court's pre-*Zmuda* opinion in *O'Neill* v. *Commissioner*, 271 F.2d 44, 49 (9th Cir. 1959), and the post-*Zmuda* opinion of Judge, now Justice, Kennedy in *Betson* v. *Commissioner*, 802 F.2d 365, 367 (9th Cir. 1986) ("A corporation exists for tax purposes if formed for a business purpose or if it carries on business after incorporation.").

Concern regarding the tax advantages of a particular investment transaction is no justification for a lower court decision that is in clear contravention of this Court's pronouncements. Here, the court below was quite concerned about the tax-motivated aspects of the PPN purchase and sale. App. 16a. But that concern properly goes to the question of economic substance (an issue left unaddressed by both courts below), and not to whether a partnership that invests its capital in a wide range of financial instruments for a period of 25 months is a "sham" for the entire period of its existence. The clear misinterpretation and misapplication of *Moline* by the court below requires review by this Court.[18]

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[17] (...continued)
articulation of the two-pronged *Moline* test.

[18] The D.C. Circuit also inexplicably cited *Knetsch* v. *United States*, 364 U.S. 361 (1960), as support for its view that the inquiry in "sham" cases "turns on the existence of a nontax business motive." App. 15a. In *Knetsch*, a "sham transaction" case, this Court expressly "put aside" the taxpayer's motive and applied the principles of *Gregory* v. *Helvering*, 293 U.S. 465 (1935), to decide "'whether what was done, apart from the tax motive, was the thing which the statute intended.'" 364 U.S. at 365 (quoting
(continued...)

II. The Decision Below Is in Direct Conflict with Decisions of the Second and Seventh Circuits on the Meaning and Application of *Moline*.

The decision of the D.C. Circuit is in direct conflict with decisions in at least two other circuits that have upheld the existence of an entity under the "business activity" prong of *Moline*, even though the entity was formed for a tax avoidance purpose and carried on its activity in furtherance of that purpose.

In *Northern Indiana Pub. Serv. Co.* v. *Commissioner*, 115 F.3d 506 (7th Cir. 1997), *aff'g* 105 T.C. 341 (1995), a U.S. parent company established a Netherlands Antilles subsidiary to borrow U.S. dollars in the Euromarket and on-loan the funds to the parent. The subsidiary's sole purpose was to enable the parent to avoid the U.S. withholding tax that would otherwise have been imposed on interest paid directly to foreign lenders. Respondent sought to disregard the subsidiary's role under various theories. The Seventh Circuit held that the subsidiary had to be respected under *Moline*. The court read *Moline* as standing for the proposition that:

> [A] corporation and the form of its transactions are recognizable for tax purposes, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions.

115 F.3d at 512 (emphasis added).

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[18] (...continued)

Gregory v. *Helvering*, 293 U.S. at 469) (emphasis added).

Knetsch does not in any way support the D.C. Circuit's view that the presence or absence of a business purpose is the sole test for determining sham treatment.

In *Gregg Co. of Delaware* v. *Commissioner*, 239 F.2d 498 (2d Cir. 1956), *cert. denied*, 353 U.S. 946 (1957), a corporation admittedly formed as part of a plan to avoid U.S. tax argued that it should be disregarded under *Moline*. The Second Circuit rejected the argument because the corporation had engaged in business activity by performing the functions for which it was created. Significantly, *Gregg* cited *National Investors*, *supra*, in support of its conclusion.

As can be seen, the Second and Seventh Circuits have both interpreted *Moline* as holding that an entity must be respected for tax purposes if it has engaged in bona fide business activity -- even if the entity was formed for a tax avoidance purpose and carried on its activity in furtherance of that purpose. The position of the D.C. Circuit below is thus in direct conflict with the position of at least two other circuits on this fundamental issue.[19]

Given the far-reaching significance of the question here presented, it is essential that this Court resolve the conflict that now exists among the circuits.

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[19] *See also Keller* v. *Commissioner*, 723 F.2d 58 (10th Cir. 1983), *aff'g* 77 T.C. 1014, 1030-31 (1981) (affirming, on basis of Tax Court's reasoning, decision respecting existence of professional service corporation engaged in business activity, whether or not formed for tax avoidance purpose); *Shaw Constr. Co.* v. *Commissioner*, 323 F.2d 316, 320-21 (9th Cir. 1963), *aff'g* 35 T.C. 1102, 1114 (1961) (affirming Tax Court holding disregarding corporations under *Moline* because they were formed for tax avoidance purposes and were not engaged in income-producing business activity); *Kimbrell* v. *Commissioner*, 371 F.2d 897 (5th Cir. 1967)(corporation disregarded where no valid business purpose and no business activity); *Bertoli* v. *Commissioner*, *supra* (absence of business purpose does not by itself require sham determination).

III. The Decision Below Conflicts with the Position of the Seventh Circuit and with *Commissioner* v. *Culbertson* Itself on Whether and How *Culbertson* Applies in Circumstances Such As Those Here Presented.

In addition to the conflict created by the D.C. Circuit's interpretation of *Moline*, that court's affirmance of the Tax Court's *Culbertson* analysis has created an additional conflict within the circuits requiring review by this Court. Specifically, the decision below is in direct conflict with *Evans* v. *Commissioner*, 447 F.2d 547 (7th Cir. 1971), with respect to the proper roles of IRC Sec. 704(e)(1) and *Culbertson* in determining whether persons are partners in a partnership in which capital is a material income-producing factor.

This Court's trilogy of family partnership decisions in the late 1940s[20] engendered considerable confusion among the lower courts regarding the proper test to be applied in determining whether a valid partnership had been created. H.R. Rep. No. 586, 82d Cong., 1st Sess. (1951), *reprinted in* 1951 U.S.C.C.A.N. 1781. In 1951, Congress responded to the confusion by enacting what is now IRC Sec. 704(e)(1).[21] *Id.* That provision established an objective test for determining whether a person becomes a partner in a partnership in which capital is a material income-producing factor, by focusing on whether the person acquired a capital interest in the venture.[22]

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[20] *Commissioner* v. *Tower*, 327 U.S. 280 (1946); *Lusthaus* v. *Commissioner*, 327 U.S. 293 (1946); *Culbertson, supra.*

[21] *See supra* note 10.

[22] A "capital interest" is defined in the pertinent regulations as "an interest in the assets of the partnership, which is distributable to the owner

(continued...)

In *Evans*, the Seventh Circuit held that Sec. 704(e)(1) overrides *Culbertson* in determining the status of persons as partners in any partnership in which capital is a material income-producing factor, whether or not the partnership involves family members. *Evans* involved the termination of an existing partnership and the creation of a new partnership in its place. The court held that the taxpayer's transfer to his corporation of his 50 percent capital interest in the old partnership resulted in a new partnership between the corporation and the other, unrelated 50 percent partner, even though the other partner never consented to having the corporation as his new partner.

The *Evans* court stated: "If the corporation's ownership is real then the subjective intent of the parties is not a determinative test." 447 F.2d at 550. It then quoted from an earlier Seventh Circuit decision, as follows:

> The test is no longer whether the parties acted in good faith with a business purpose in joining together to conduct a partnership business. This was the test set forth in *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949), which was decided before present Sec. 704(e)(1) was part of the Code. * * * The emphasis has shifted from "business purpose" to "ownership of a capital interest." * * *

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[22] (...continued)
of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership." Treas. Reg. Sec. 1.704-1(e)(1)(v); App. 79a. Under the terms of petitioner's partnership agreement, each partner contributing capital was entitled to a distribution of assets in proportion to its contribution, either on withdrawal or upon liquidation. (D.C. Cir. Jt. App. 0823, 0833-35.)

Id. at 551, quoting from *Pflugradt* v. *United States*, 310 F.2d 412, 415 (7th Cir. 1962).

According to the Seventh Circuit, in any case involving an unincorporated venture where capital is a material income-producing factor, the threshold test for determining a participant's status as a partner in a partnership is whether the participant acquired a capital interest in the venture.[23] (Like the Seventh Circuit, the Tax Court has applied Sec. 704(e)(1) in considering the status of persons as partners in newly-created partnerships. *See, e.g., Ketter* v. *Commissioner*, 70 T.C. 637 (1978), *aff'd without opinion*, 605 F.2d 1209 (8th Cir. 1979); *Carriage Square, Inc.* v. *Commissioner*, 69 T.C. 119 (1977).)

Here, the D.C. Circuit concluded that whether ABN made a capital contribution to, and thereby acquired a capital interest in, petitioner was "quite peripheral to the central issue of whether the parties entered into a bona fide partnership." App. 22a. Its refusal even to consider the question puts it in direct conflict with the Seventh Circuit on this point.

In addition, the D.C. Circuit's failure to acknowledge the relevance of whether ABN had made a capital contribution to petitioner constitutes a clear misapplication of *Culbertson* itself. This Court there made it clear that all facts and circumstances are to be considered in determining whether a bona fide partnership has been formed. In summarizing the analysis contemplated by *Culbertson*, this Court confirmed that

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[23] Under the Seventh Circuit's test, *Culbertson* remains relevant where the participant has not acquired a capital interest in the venture, as the Tax Court concluded below with respect to ABN, or where capital is not a material income-producing factor in the venture.

The Fifth Circuit apparently takes a contrary view. *See Bayou Verret Land Co.* v. *Commissioner*, 450 F.2d 850 (5th Cir. 1971).

whether a participant has contributed capital to the venture is one critical factor that cannot be ignored.

> If, upon a consideration of all the facts, it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient.

337 U.S. at 744-45. The D.C. Circuit's failure to recognize the relevance of whether ABN had made a capital contribution to petitioner reflects a complete misunderstanding of *Culbertson*. Under either *Culbertson* or Sec. 704(e)(1), therefore, the court's refusal to determine the nature of ABN's cash outlay conflicts with the governing law.

IV. The Instant Case is One of Considerable Importance In the Area of Partnership Taxation Involving Corporations.

The instant case raises fundamental issues affecting partnership taxation in a nonfamily setting. The questions here presented are particularly significant in the current tax environment. Lower courts are being asked with considerable frequency to determine whether the use of a particular business or investment structure by a corporation, or the implementation of a particular series of transactions, constitutes an acceptable "tax minimization plan" or an unacceptable "corporate tax shelter."

Fundamental questions such as those here involved go to the very essence of that determination. Partnerships are the entity of choice for many commercial and financial joint ventures entered into by unrelated corporations. Yet, this Court

has not revisited the basic partnership issues here presented since Congress enacted the predecessor of Sec. 704(e)(1) in 1951.

Moreover, the D.C. Circuit is the only circuit for appeals by partnerships no longer in existence. If the decision below is left unreviewed, the outcome for two virtually identical commercial partnerships formed by the same participants will almost certainly be different if, by the time their status is challenged, one partnership has been terminated and must appeal to the D.C. Circuit, while the other remains in existence and is able to appeal to the Seventh Circuit or to another circuit that agrees with the positions of that court in this area.

Review of the decision below will afford this Court the opportunity to resolve the conflict between the D.C. Circuit and the other circuits on the applicability of *Moline* and of Sec. 704(e)(1), as well as to clarify how *Culbertson* is intended to be applied in a nonfamily context in the event Sec. 704(e)(1) does not apply.

CONCLUSION

For all of the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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